Chevron

Chevron Federal Credit Union

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James E. Mooney
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Mr. Gerald Poliquin
Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Proposed Rule — Prompt Corrective Action — Risk-Based Capital

On behalf of Chevron Federal Credit Union, I thank you for the opportunity to comment on the National Credit Union Administration's proposed rulemaking on Prompt Corrective Action and risk-based capital.

In the aftermath of the financial crisis, we welcome NCUA's consideration of a systematic risk-based capital rule. Over the years, it has been our practice to establish optimal net worth levels based on careful assessment of the risks inherent in our balance sheet. Chevron Federal Credit Union ended 2013 with a net worth ratio of 10.3%, slightly above our targeted level of 10.0%. Under NCUA's proposed rule, the Credit Union's risk-based net worth ratio for that same period would have been 14.3%, well above the proposed 10.5% requirement for a "well capitalized" designation.

As with everything we do, our evaluations of optimal capital are intended to enable us, ultimately, to effectively serve our members. In this context, recent comments from two well-informed sources are particularly pertinent to NCUA rulemaking:

> *"Credit unions must remain relevant in the mix of financial services options available to the American public… A credit union that is safe and sound, but irrelevant to its members' needs is not a viable outcome of regulation."*
>
> *You will need to grow. Holding your ground is not going to work. Staying the same will not be an option.*

The foregoing statements were made by the Honorable Richard Metsger and the Honorable Michael Fryzel, respectively, at this year's CUNA Government Affairs Conference (as quoted in the *Credit Union Times*). We heartily concur with Messrs. Metsger and Fryzel. Our belief – and concern – is that the proposed rule would indeed make credit unions less relevant by chaining them to old operating models that no longer serve their members.

We wish to focus our comments on three areas of particular concern and offer our suggestions to improve the proposed rule:

Residential Mortgages

The proposed rule assigns risk weights for residential mortgages of 50% to 100% for first mortgages and 100% to 150% for other residential mortgages. We make the following observations and suggestions:

- We understand that the risk weights for residential mortgages – which are higher than the 50% weighting for first mortgages and 100% weighting for other residential mortgages that apply to banks – are intended to address concentration and interest rate risks. In effect, NCUA's proposed rule goes beyond the application of Basel III standards for banks, which only consider credit risk. We believe that NCUA is applying a very simple, limited tool for purposes in which it is not well suited.

    - Perhaps the most significant deficiency in the proposed rule is that, in seeking to address interest rate risk, it fails to consider the source of such risk, namely a mismatch of the maturities of assets and liabilities. The Basel III model focuses purely on assets, not potentially risk-mitigating liabilities such as long-term borrowings. It simply was not built for this issue.

    - Even in its narrow focus on assets, the proposed rule fails as an effective means of measuring and controlling interest rate risk. Not all residential mortgage programs are the same: some are comprised largely of adjustable rate loans, others primarily long-term fixed rate loans. The portfolio composition has significant implications for interest rate risk, but is not considered in the proposed rule.

    - For our credit union, which has effectively managed interest rate risk for over 14 years through the Investment Pilot Program, there is another glaring omission in the proposed rule: no consideration of interest rate derivatives. With NCUA's new derivatives rule now in place, this may become an issue for an increasing number of credit unions. As it currently stands, the proposed rule provides no offset in capital requirements for residential mortgages regardless of a credit union's deployment of such risk mitigation tools.

- The proposed risk weightings for residential mortgages, as well as some other asset categories, clearly signal a concern about concentration risk. However, this concern is applied unevenly in the proposed rule: there are limits for residential mortgages but none for, say, auto loans or credit cards. Clearly, concentration risk is serving in the proposed rule as a proxy for interest rate risk. The most effective means of monitoring interest rate risk is through the existing examination process, in which the totality of risk exposure and mitigation can be considered, and, if necessary, addressed operationally. With interest rate risk thus addressed, asset concentration becomes far less problematic. A high concentration of carefully underwritten residential mortgages with low loan-to-value ratios and high credit scores (such as our existing portfolio) may offer a more satisfactory risk profile than a high concentration of unsecured credit cards. We would therefore encourage NCUA to reconsider its focus on concentration risk.

- The financial crisis and subsequent collapse of the housing market in many regions, including the Credit Union's home base of California, is instructive for evaluating inherent risks in our residential mortgage portfolio. With average loan-to-value under 60% and average borrower credit scores in excess of 750 pre-crisis, the Credit Union was well-positioned to lend when many banks pulled back. This was not uncommon among other credit unions. Given these results during the most tumultuous real estate lending environment in several generations, we believe the capital weightings applied to banks may be excessive when applied to credit unions.

The proposed rule as applied to residential mortgages is ill-suited for its intended purpose of limiting systemic interest rate risk. Moreover, in setting capital standards that are more stringent than those applied to banks, the proposed rule will impede our ability to compete in the area of greatest need for our members – residential mortgages.

Cash and Investments

The proposed rule assigns risk weights of 20% for funds on deposit at financial institutions and risk weights of 20% to 200% for investments based on duration. We make the following observations and suggestions:

- The 20% risk weight for funds on deposit at financial institutions includes funds at the Federal Reserve Bank (FRB). Cash on deposit at the FRB is liquid and has an implied guarantee from the U.S. government. We understand that Basel III recognizes this implied guarantee and assigns a 0% risk weight to FRB deposits. We do not believe credit union funds deposited at FRB carry any greater risk than bank deposits at FRB.

- Similarly, securities issued by government-sponsored entities (GSEs) carry either an explicit or implied guarantee from the U.S. government. The credit risk portion of any risk weighting plan should reflect the risk-free nature of such investments. With government backing similar to deposited funds at FRB, investments in GSE-issued securities should carry a similar 0% risk weight.

- The proposed rule provides for higher risk weightings for longer duration investments, presumably in an attempt to address interest rate risk. However, as with residential mortgages, the Basel III model adopted for the proposed rule is too limited for purposes of interest rate risk mitigation. One side of the balance sheet is simply insufficient. Additionally, the proposed rule fails to recognize the implications of the portfolio composition: variable-rate securities have a much different interest rate risk profile than fixed-rate securities.

As with residential mortgages, the objectives of the proposed rule pertaining to investments are not effectively accommodated by a simple asset-based risk weighting. Interest rate risk cannot be effectively measured from just one side of the balance sheet. Additionally, the proposed rule as applied to cash and investments further and unnecessarily distances credit unions from banks in capital requirements.

Risk-Based Capital Ratio Requirement

The proposed rule sets a 10.5% threshold for credit unions to be classified as well-capitalized. On the surface, the 10.5% risk-based capital threshold is consistent with Basel III guidelines that mandate banks to maintain an 8.0% total risk-based capital ratio plus a 2.5% capital conservation buffer to attain classification as "well-capitalized." However, the stated purpose of the capital conservation buffer is to ensure that banks are only able to pay stock dividends and certain shareholder/employee payments if they maintain the minimum 2.5% buffer beyond the 8%. Falling below the 2.5% buffer requires banks to begin curtailing shareholder distributions and certain employee payments, but has no impact on their ability to pay interest to their depositors.

The capital conservation buffer has a specific application in banking but has no applicability to credit unions, as our shareholders and depositors are indistinguishable. Imposition of the additional 2.5% again requires credit unions to hold much more capital than our banking counterparts without any risk basis.

Conclusion

The proposed risk-based capital rule attempts to enhance the Basel III model by incorporating provisions to address interest rate risk and, analogously, concentration risk. However, when applied to residential mortgages and investments, this objective is far too ambitious for Basel's simple asset-based risk weighting. We believe such risk considerations are most appropriately addressed under NCUA existing examination regimen.

In evaluating these and other comments, I am hopeful that NCUA will remain cognizant of the sentiments quoted above from Messrs. Metsger and Fryzel. Credit unions must have the capacity to grow, to change, to adapt to meet our members' needs. The financial world has not simply changed since passage of the Federal Credit Union Act; it is virtually unrecognizable from that perspective. However, the proposed rule, with its stringent capital requirements in nearly every area save consumer loans, appears more oriented toward 1934 than 2014.

We believe that interest rate risk – the obvious focus of the proposed new rule – will be a critical challenge for the industry in coming months and years. We do not believe, however, that the asset-based risk weighting model presented in the proposed rule is up to the challenge.

Thank you for considering our comments.

Sincerely,